Pursuant to D.T.E. 02-40-B:

Comments on the Investigation by the Department of Telecommunications and Energy on its own Motion into the Provision of Default Service

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In its recent Order on the Investigation by the Department of Telecommunications and Energy on its own Motion into the Provision of Default Service, the Department (DTE) invited comments, *inter alia*, on its suggested introduction of monthly default service procurement terms for larger consumers.[1] The Department also requested comments on whether it was appropriate to consider monthly procurement terms for smaller consumers as well. In response to this request we provide the following comments.

First, we want to endorse the Department's initiative with respect to default service provision, as the importance of this service to emerging electricity markets cannot be emphasized enough. As residential consumers[2] of electricity who have not been able to procure supplies competitively, we agree with the Department that default service may continue to be important to various consumer classes beyond 2005. The acknowledgement that default service consumers represent a large portion of electricity demand is of crucial importance.

Our primary concern reflects our belief that the Department may not be giving sufficient attention to the impact default service policy may have on the health of bulk power markets. Of particular concern is the short-term nature of default service procurement and pricing for those consumers that currently have little or no opportunity to elect a new supplier. Although short-term procurement is appropriate for a genuine transition service that will serve as a temporary backstop, it is inconsistent with the long-term health of the wholesale market to have a substantial amount of demand relying on short-term markets. If we expect that default service will be needed for more years than originally expected, then the Department must carefully consider its default service policies and provide sufficient flexibility within its policies to permit occasional adjustments.

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[1] Order on the Investigation by the Department of Telecommunications and Energy on its own Motion into the Provision of Default Service, Docket D.T.E. 02-40-B, April 24, 2003, at 40.

[2] The authors are Senior Consultants at Lexecon Inc. whose focus is the restructuring of the U.S. electricity industry. These comments represent only those views of the authors, and we accept responsibility for any and all errors. The authors thank Lexecon Inc., and in particular Zeljka Bosner and Marin Boney for their assistance in the preparation of this submission.

To put this concern in context, we first note that one of the primary expectations of electricity industry restructuring was that future competitive electricity markets would eliminate the need for regulatory oversight of much power market activity. In particular, it was believed that following a transition period where consumer pricing was disconnected in varying degrees from underlying market fundamentals, price signals in retail markets would eventually emerge and provide consumers with information necessary to economize usage. At the same time appropriate wholesale price signals would be transparent and provide investors with incentives to construct new capacity. The combination of accurate price signals in both markets (i.e., wholesale price variations transparently reflected in retail prices as applicable) would lead to investment and conservation undertaken with little regulatory oversight. The results thus far have been mixed: While larger consumers are being pursued by competitive suppliers, the lack of competitors for smaller consumers has created a difficult situation, resulting in what will likely be a longer transition period than was originally expected. As such, default service may become an unexpected long-term or even permanent option for certain retail consumers.

The approach that is taken to regulate the procurement activities necessary for default service will have a significant impact on the wholesale markets. For example, in Massachusetts (and other New England States), the vertical integration that characterized the electricity industry prior to restructuring has been eliminated. The acknowledgement that long-term supply contracts are the substitute for the prior vertical integration is of critical importance when evaluating default service procurement policies that could impact a significant quantity of electricity demand. Because power plants typically require long-term supply contracts to obtain financing, default service procurement policies need to be carefully considered vis-à-vis their wholesale market impacts.

Therefore, so long as a default service option is available to all consumers, care needs to be taken to ensure that its pricing policies are consistent with the needs of the wholesale market. As has been emphasized recently, a healthy wholesale market allows suppliers to obtain some certainty

that their future production can be sold by transmitting signals from underlying consumers. A lack of forward contracting prevents suppliers from receiving important signals as to the value of and need for future production. Default service must not impede the transmission of these signals. Although this may not be a significant concern now with a significant excess of new supplies, it could become a problem in the future when the market has absorbed the new supplies and investors demand revenue certainty before constructing new generation facilities.

Considering the objective of ensuring a healthy wholesale market, we offer the following specific comments. First, we support and encourage the Department's suggested monthly procurement process for larger consumers. We recognize that this will require some adjustment by distribution companies, but the benefit of the improved price signals is enormous. The attached Figures 1 and 2 compare the following using Boston Edison industrial and commercial demand as an example: 1) the default industrial and commercial electricity rates that have been in effect for the utility since competition was introduced; 2) an estimated cost to supply this service assuming that the energy component was exclusively procured hourly on the wholesale spot market; and 3) an estimated cost to supply this service assuming a portion of the energy component was procured on a monthly basis (procuring certain fixed amounts at wholesale one month prior to the delivery month and procuring the balance in the hourly spot market). The depicted default rates are exactly those that were charged during the time period shown. The estimated spot market and spot/forward energy market cost estimates are shown as month-by-month average implied rates that include a two cent/KWh adder to account for transmission service, losses, capacity, ancillary services, and load volatility costs.

These charts were developed to permit the comparison of proxy default service rates based on prevailing wholesale spot and forward market prices with default service rates that prevailed concomitantly. For example, because default procurements occur somewhat infrequently and set prices at a single point in time for several months into the future, it is not unusual to ask what types of retail

prices might have prevailed if procurement were handled differently, as the Department has proposed. The lines labeled "implied rates" represent an estimate of what costs a supplier might have incurred had it used the specified approach to serving default service.[3] One line represents cost estimates based on a straight pass-through of hourly spot market energy prices as reported by ISO-New England. Another line represents cost estimates assuming a portion of the energy commodity was purchased in the forward market while the balance was purchased in the hourly spot market. Depicting these alternative procurement approaches as monthly averages allows the observation of the type of price variance that can occur if default service is procured differently – in this case over a shorter time horizon, as the Department has proposed for larger consumers.

From these results we can make a couple of observations of interest. For example, we see how the default service rates were primarily set every six months and we can see how the realized prices varied as prices in electricity forward contract markets varied during that time period (if a several-month procurement were made at a time when forward prices were elevated, these elevated prices carried forward for six months). We can also see how the introduction of monthly rates will much more accurately track the wholesale markets. Significant lags are introduced when rates are established time-to-time as opposed to more often. Consumers will be far more aware of the cost of electricity if rates are reset more often.

Our expectation is that some large consumers who value price certainty (e.g., for budgeting purposes) and who face these more variable rates may have a significant incentive to investigate the availability of a longer-term, more stabilized electricity price that a competitive supplier would offer (as many already have during the transition period). Consumers that sign these types of contracts with competitive suppliers will be signaling the need for capacity to

[3] The depicted cost estimates are not meant to exactly replicate the price (rate) a provider might have set to provide default service, but instead are meant to be reasonable estimates of the costs of meeting default service loads. A similar approach with a more exhaustive evaluation of the

meet their demands now and in the future; varying rates monthly may thus be an important step forward to providing for a healthy wholesale market.

Although we firmly support this monthly procurement approach, we recommend that the Department consider having these consumers' default service be priced on an hourly basis to further ensure that consumers have an incentive to shop. We recognize that the Department is reluctant to use hourly pricing because it is concerned that the pass-through of extreme price spikes might cause substantial financial harm to some customers and might be perceived as "punitive." As the Department knows, there is a natural tension between the desire to provide regulatory protection against price volatility and the hope that customers will seek such protection from marketers who will offer price stability at a price. While the Department is clearly not ready to introduce hourly pricing at this point, we suggest the Department remain open-minded on this point as it continues to monitor the future development of the retail market. Generally, we believe that it is a simple proposition to have larger consumers face hourly rates as a default outcome given the introduction of nodal pricing by ISO-New England. This risk will likely ensure that the majority of larger consumers make arrangements with competitive suppliers in order to hedge a potentially volatile hourly spot market.

Our final comment relates to the procurement term for smaller consumers. We do not recommend that the Department shorten the procurement time period for smaller consumers. The fact is that competitive suppliers have not come forth to serve these consumers and it may be that competition to serve these consumers will not ensue for the next few years. Considering the need for a healthy wholesale market, the Department might actually consider developing a policy whereby the potential competitiveness of the retail residential market is evaluated to determine how to approach the establishment of a procurement time-frame for these smaller consumers. We should note that the Department's proposed new procurement approach does not need to eliminate small consumer

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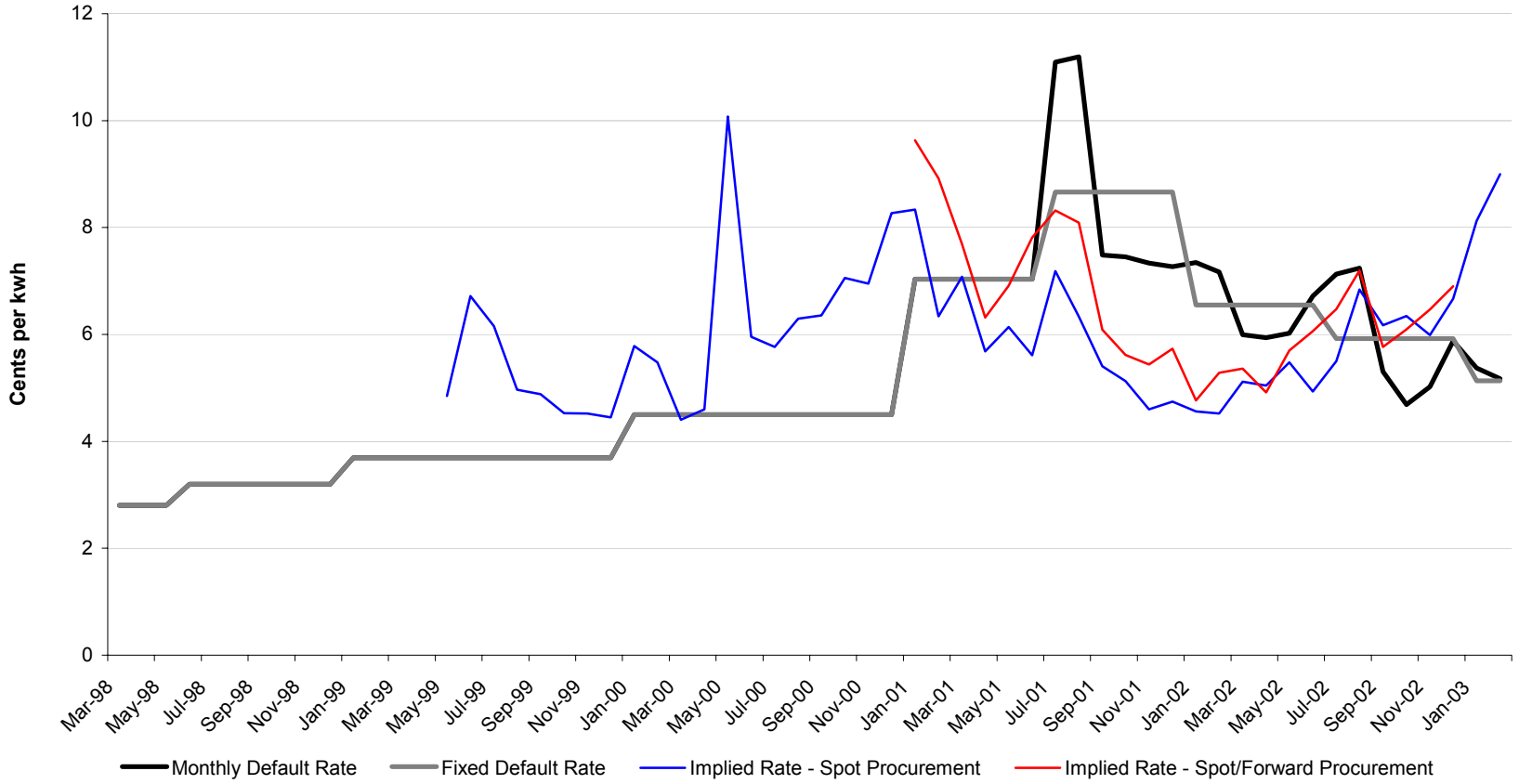
impact of expected spot market price variation would be carried out by a supplier when calculating an actual offer price.

price variations; it is feasible to implement modified rate structures for these smaller consumers that require them to make decisions, but at the same time offer them some price certainty.[4] The combination of more flexible forward contracting with efficient rate structures can help ensure that a portion of the demand that is currently not being registered in the longer-term forward markets signals when new capacity will be required in the future, while not completely insulating consumers from wholesale market price variations.

We know that any policy articulated by the Department that continues to shield residential consumers from accurate price signals is problematic given the State's move toward retail competition, but at the same time without new competitors residential consumers will face rates that do not provide any price certainty. Although shorter-term procurements would cause some consumers to take notice of their bill (as they likely already have, given the substantial price variation that occurred during the last couple years), it does not provide them any benefits that could be available from the competitive market. Careful monitoring of the extent to which the retail market for residential consumers develops, combined with interim policies that take advantage of opportunities for creating price stability (in part by incenting consumers to pay attention to their service through appropriate rates) and providing accurate signals to the forward markets, can result in a mutually beneficial transition period for both consumers and producers. Surely this is not the solution we have all been expecting, but taking note of the realities of the marketplace is critical. As such, we recommend that the Department resist further reducing the procurement period for small consumers, but instead consider carefully the impacts of its policies on the underlying wholesale market. The argument can be made that the procurement period should be even longer to properly signal the forward markets.

[4] For example, these consumers' rates could be modified to introduce pricing based on an estimated fixed block of supply that a consumer can identify with true-ups due to variations priced at the hourly wholesale price.

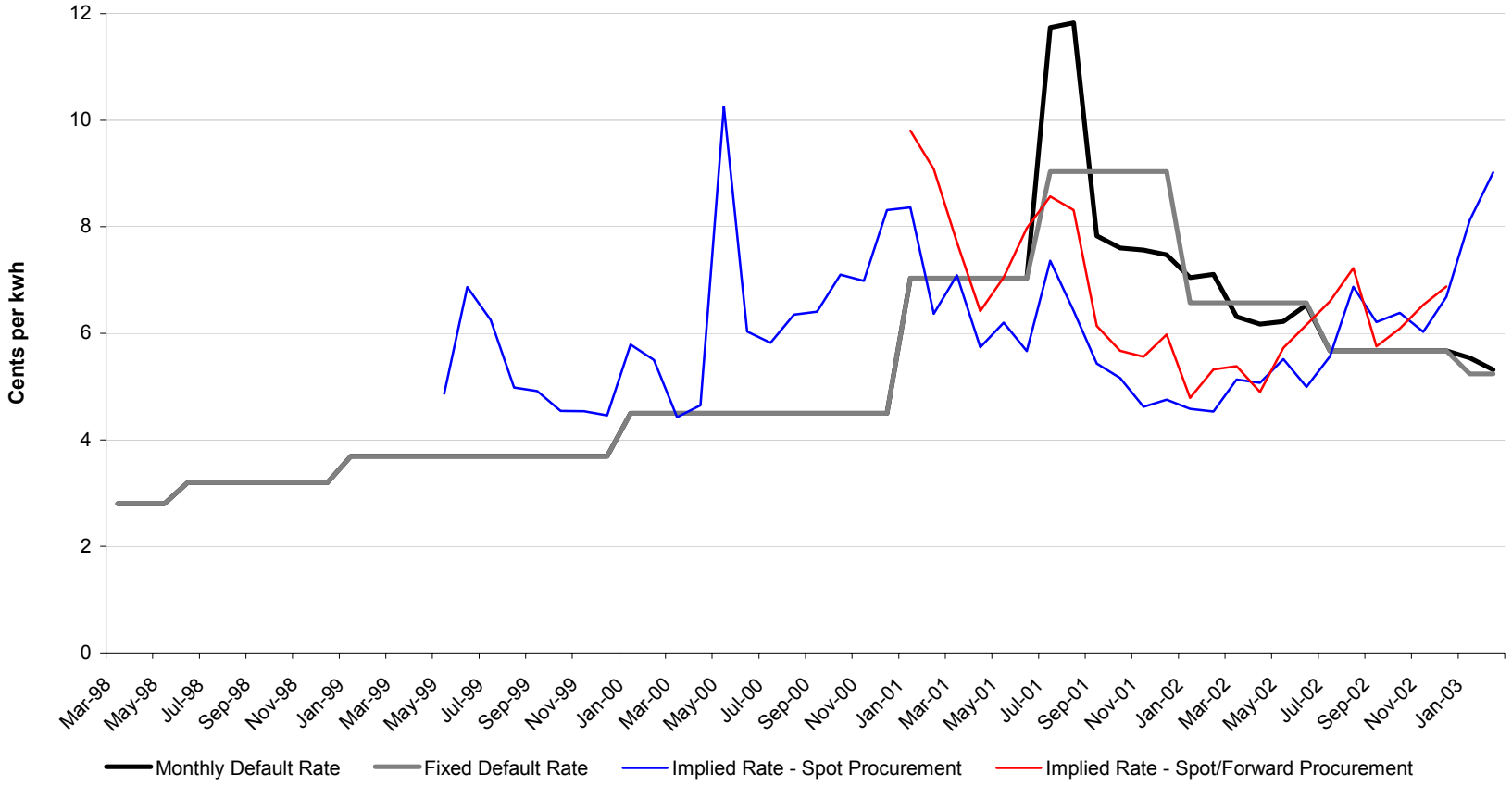
Figure 1
BOSTON EDISON INDUSTRIAL DEFAULT RATES v. IMPLIED MONTHLY RATES
CALCULATED USING SPOT PRICES AND SPOT/FORWARD PRICES



Notes:
1) Demand based on historical hourly Boston Edison industrial loads.
2) Spot and spot/forward implied rates include a 2 cent/kwh adder for transmission, ancillary services, capacity and load volatility costs.
3) Monthly implied spot rate assumes that all energy demand was satisfied with purchases in the hourly spot market.
4) Monthly implied spot/forward rate assumes that portions of monthly energy demand were purchased forward while the balance was purchased in the hourly spot market.

Sources: Natsource, Power Markets Weekly, FERC Form 714, Massachusetts DTE, ISO-NE.

Figure 2
BOSTON EDISON COMMERCIAL DEFAULT RATES v. IMPLIED MONTHLY RATES CALCULATED USING SPOT PRICES AND SPOT/FORWARD PRICES



Notes:
1) Demand based on historical hourly Boston Edison commercial loads.
2) Spot and spot/forward implied rates include a 2 cent/kwh adder for transmission, ancillary services, capacity and load volatility costs.
3) Monthly implied spot rate assumes that all energy demand was satisfied with purchases in the hourly spot market.
4) Monthly implied spot/forward rate assumes that portions of monthly energy demand were purchased forward while the balance was purchased in the hourly spot market.

Sources: Natsource, Power Markets Weekly, FERC Form 714, Massachusetts DTE, ISO-NE.